



Guidelines on Performance Evaluation of Board of Directors



Banking Policy & Regulations Department

State Bank of Pakistan

Team

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Foreword

Good governance is pivotal in helping the business to deliver its strategies whilst generating sustainable shareholder value and balancing competing demands of other stakeholders. It revolves around the basic principles of fairness, integrity, transparency and accountability with prime focus on the role and composition of the board of directors.

The board has the ultimate decision-making authority and is responsible to (a) set the company's policy, objectives, and overall direction, (b) adopt bylaws, (c) hire, monitor, evaluate and fire the CEO and senior executives, (d) determine and pay the dividend, and (e) issue additional shares. An effective board with appropriate skill mix and competencies can significantly enhance the performance of a bank/DFI. Therefore, the performance evaluation is vital to determine the strengths as well as weaknesses of overall board, its committees and individual board members in order to increase their overall effectiveness.

The performance evaluation of board is the proactive approach to gauge the contribution of individual board members and committees towards achieving the strategic goals of a financial institution in the long run. Hence, a continuous and regular performance evaluation of board can help banks/DFIs to:

- ❖ Measure level of awareness of key board responsibilities
- ❖ Establish current baseline of board's performance
- ❖ Identify critical gaps in key areas of board effectiveness
- ❖ Measure degree of alignment among board members
- ❖ Focus on high impact, low performance areas
- ❖ Enable boards to quantify their interaction and effectiveness
- ❖ Create board effectiveness improvement plan
- ❖ Execute and follow up on improvement plan

As the regulator and supervisor of banks, State Bank of Pakistan (SBP) has a crucial role in steering the corporate governance reforms for banking sector. In this regard, SBP has implemented a comprehensive corporate governance regime for banks, which is driven by a robust legal and regulatory framework. With the intention to further strengthen corporate governance regime and to bring uniformity in the existing practices of performance evaluation of boards, the guidelines on performance evaluation of board of directors have been developed. These guidelines will provide the basic mechanism, techniques and approaches through which the performance of the boards shall be evaluated. Keeping in view the size, complexity and structure of the institution, the board can formulate its performance evaluation framework in the light of these Guidelines.

A. Performance Evaluation Mechanism

One of the main responsibilities of the board is to put in place a formal and rigorous process for regularly reviewing its overall performance as well as performance of individual directors and its committees. The board performance evaluation is not simply a control mechanism over board members, but a tool to identify areas of governance improvement. Besides regulatory compliance, the performance evaluation mechanism shall cover all aspects of board's structure, size, composition, responsibilities and processes including detailed analysis of the aspects where the board thinks it can improve and plan an action to address issues.

1. Performance Evaluation of the overall Board

The board needs to act on a fully informed basis in the best interest of the institution and its stakeholders. The board has overall responsibility to approve and oversee implementation of the bank's strategic objectives and to set 'tone at the top' in order to promote a sound corporate culture. The following are some of the specific issues/questions that should be considered in performance evaluation of a board:

- a) Is the composition of the board appropriate, having the right mix of knowledge, expertise and skills to maximize performance?
- b) How well the board exercises its role ensuring that the organization supports and upholds the vision and mission, core values etc.?
- c) Is the policy framework of bank/DFI developed appropriately?
- d) What has been the board's contribution towards developing strategies?
- e) Is the board able to make timely strategic decisions ensuring operations are in line with strategies?
- f) Is the information provided to the board appropriate, accurate, timely and unbiased?
- g) What has been the board's contribution in ensuring robust and effective risk management?
- h) Has the board ensured that internal control and the audit function are conducted in an effective manner?
- i) Has the board ensured timely and accurate disclosure on all material information?
- j) Is the board as a whole, up-to-date with latest developments in the regulatory environment?
- k) Are the board procedures conducive to effective performance and flexible enough to deal with all eventualities?
- l) Is the board effective in adherence to the code of conduct?

2. Performance Evaluation of the Chairperson

The chairperson has the overall responsibility of the board evaluation and should select scope, approaches and techniques of evaluation process. Nevertheless, the performance of chairperson also needs to be evaluated which is linked to both the functioning of the overall board as well as the performance of each director. The main responsibility of evaluating chairperson's performance rests with independent directors who shall

carryout this task with the help of other directors especially keeping in view the following aspects:-

- i) Has he demonstrated effective leadership qualities?
- ii) Has he managed good relationship with all other members of the board, management and shareholders?
- iii) Are all directors encouraged to participate and raise issues and concerns in board discussions?
- iv) Are conflicts effectively resolved?
- v) Is constructive debate and effective decision making promoted?
- vi) Is shareholders' confidence in the board promoted?

3. Performance Evaluation of Individual Directors

a) Following are some of the specific issues/questions that should be considered in the performance evaluation of individual directors:

- i) How well prepared and informed are they for board/committee meetings?
- ii) Is their attendance of meetings satisfactory?
- iii) How good has been the quality and value of their contribution at board/committee meetings?
- iv) Do they effectively impart their knowledge and expertise?
- v) Do they demonstrate a willingness to devote time and effort to understand the bank/DFI and its business and a readiness to participate in events outside the board room?
- vi) How successfully have they brought their knowledge and experience in formulation of strategies?
- vii) How effective and successful are their relationships with fellow board members, the company secretary and senior management?
- viii) Are they good in terms of integrity and maintaining confidentiality?

b) In addition to the above parameters, following may also be considered for the evaluation of sponsor directors:

- i) Are they involved in day to day affairs of the institution?
- ii) Are they influencing the board against the interests of other stakeholders?
- iii) Are they undermining the role of CEO?
- iv) Are they involved in related party transactions/insider trading?

4. Performance Evaluation of Independent Directors

The performance evaluation of independent directors shall be carried out by the entire board excluding the director being evaluated. In addition to the parameters laid down for other directors (as mentioned in point A-3 above), the performance evaluation of independent directors shall also include the following aspects:

- i) Are they able to exercise their objective and independent judgment in the best interest of the bank/DFI?
- ii) Are they able to demonstrate the transparency and fairness in their role?

- iii) Are they able to confront the management/sponsors whenever required?
- iv) Are they playing an active role to enhance the overall effectiveness of the board?
- v) Are they effectively protecting the sanctity of `Independence` in a board which mainly comprised of sponsors or their nominees?
- vi) Are they able to contribute to, and monitor good corporate governance practices?

5. Performance Evaluation of CEO

The performance evaluation of CEO of a bank/DFI shall be carried out by all the directors. The following are some of the specific issues/questions that should be considered in the performance evaluation of CEO:-

- i) Were the financial/business targets set by the board achieved?
- ii) Does he possess leadership qualities i.e. correct anticipation of business trends, opportunities and priorities affecting the institution's prosperity and operations?
- iii) Has he developed clear mission statement, policies, and strategic plans that harmoniously balance the needs of all the stakeholders?
- iv) Does he ensure that company's resources and budgets are aligned with the implementation of the organization's strategic plan?
- v) Does he establish an effective organization structure to ensure management's focus on key functions?
- vi) Does he timely and effectively execute strategies set by the board?
- vii) Has he served as an effective representative while communicating with all the stakeholders?

6. Performance Evaluation of Committees

The rationale for the formation of board committee is to enhance the efficiency and to share the work load of the board. The performance of the committees may be evaluated on the basis of the terms of reference of the respective committees. Following are some of the specific issues/questions that should be considered in the performance evaluation of committees:

- i) Are the size, structure and skill set of committees appropriate?
- ii) Does each committee have adequate and appropriate written terms of reference?
- iii) Are the committees effectively discharging their functions and duties as per terms of reference?
- iv) Is the frequency of committee meetings adequate?
- v) Are the committee meetings organized properly with appropriate procedures?
- vi) Are the committee meetings conducted in a manner that encourages open communication and meaningful participation of its members?
- vii) How effectively and proactively committees have followed up with their areas of concern?
- viii) Are the suggestions and recommendations of committees effective?

B. Approaches for Performance Evaluation

The chairperson may adopt any of the following approaches for performance evaluation of overall board, committees and individual directors:

1. In house Approach

In house evaluation is easy and simple as all board members are familiar with each other and overall dynamics of the board room. However, the issue of bias cannot be ruled out in the evaluation process which can give rise to conflict of interest. There may also be a natural reluctance amongst directors to be completely open on sensitive issues with other directors, particularly the chairperson. To counter this issue, evaluation committee can play an important role in overall performance evaluation of board members as they are generally responsible for their selection and appointment on the board. The company secretary shall assist the chairperson/committee in the performance evaluation process. The members responsible/involved in the process of performance evaluation of the board may be given training on various evaluation techniques to achieve the desired results.

2. Third Party Approach

The performance evaluation by an external third party can bring objectivity to the whole process. External evaluator can give an independent view and perspective about overall performance of board. Third parties may include general advisors, specialized consultants and specialized institutes like Pakistan Institute of Corporate Governance, Institute of Chartered Accountants of Pakistan, Institute of Cost and Management Accountants, Pakistan Institute of Management etc. The third party evaluation can be more transparent, time saving and free from bias. The involvement of an independent external evaluator could provide some reassurance to shareholders and other external stakeholders that the evaluation has been rigorous and objective. The results shall be sent to the chairperson that is to be communicated internally to all board members. However, the selection of external evaluator can be a major concern especially in terms of cost/benefit analysis.

3. Both (In house and Third Party)

The boards of banks/DFIs may adopt a mix of both approaches (in house and third party) also. External facilitators may provide institution specific survey forms/questionnaires which are technically prepared in light of best international standards for evaluation process. The boards can either:

- i) Take survey forms/questionnaires from the external facilitator and undergo the whole evaluation process within the institution, or
- ii) Formulate and fill in the questionnaires within the institution and analysis/result can be outsourced to an external facilitator.

C. Techniques for Performance Evaluation

The boards may adopt the following techniques while carrying out the process of performance evaluation:

1. Quantitative

Quantitative techniques can be administered face to face, by web portals or emails. Such techniques includes surveys using scaled questionnaires for example from 1-5 (5 for outstanding or excellent performance and 1 for performance that is non-existent or needs improvement). General comments/remarks can also be solicited in the surveys.

2. Qualitative

Qualitative techniques include in depth analysis of the responses through interviews, observations, informal bottom-up appraisals etc. Interviews can be conducted face to face or via telephone if there are limitations of time or distance. An informal bottom-up appraisal includes the management's perspective on the board's effectiveness.

D. Result/Outcome

The result/outcome of the performance evaluation shall include:

- a) Performance report of overall board
- b) Performance report of individual board members
- c) Performance report of committees

The chairperson shall discuss the results/findings collectively with each individual board member along with feedback sessions. The chairperson should dedicate adequate time to discuss the results of the board evaluation as the same shall constitute a major input for consideration for re-appointment of board members.

E. Frequency of the Performance Evaluation:

The boards of banks/DFIs shall annually evaluate performance of overall board, its committees and individual directors whereas the same shall be undertaken (facilitated) by an external independent evaluator at least every three years.

F Disclosure

The stakeholders are mainly keen to understand the evaluation process by which the board approaches the task of continuously improving itself. The annual report shall include the in-depth disclosure of the complete mechanism adopted and the approaches & techniques used in the performance evaluation process.

G Action Plan

Subsequent to the performance evaluation process, the identified issues, weaknesses and challenges need to be addressed adequately through a proper action plan. The chairperson or the concerned board committee responsible for the performance evaluation process shall also formulate the requisite strategies and action plans to address the identified challenges/issues.
